Acquisitions, Dispositions & Structuring Techniques Corner

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Deducting the Cost of Manager Indemnification

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Almost every LLC agreement contains a "boilerplate" provision that the limited liability company will indemnify the manager for any costs or expenses which are incurred as a result of the manager's service. These provisions are frequently derived from the similar provisions used by corporations to indemnify directors. Without such assurances, no rational person would agree to serve as the manager of a limited liability company or as a director of a corporation.

In most "routine" situations in which this indemnity comes into play, a limited liability company is sued, and the managers are named as defendants in the lawsuit. If the lawsuit arose in the ordinary course of the company's business (*i.e.*, a "slip and fall" or some other normal business-related claim), the expense incurred by the company would be an ordinary and necessary business expense. If the manager is also sued, and assuming that the manager was acting in her capacity within the limited liability company, there appears to be little question that the company could deduct any indemnification payment that is made in the same way that the company can deduct the expenses it incurs on its own behalf.

However, sometimes the indemnification could be incurred in connection with a capital transaction. For example, assume that a limited liability company is involved in an acquisition, and the transaction leads to litigation involving both the company and its managers, with plaintiffs claiming that the company and its managers are jointly and severally liable. If a capital transaction results in litigation, one may think that all of the legal fees incurred thereby must be part of the acquisition and capitalized. The analysis of such litigation expenses is driven by the Supreme Court's "origin of the claim" test. However, the characterization of all of the legal fees may not necessarily be strictly determined by the presence of the capital transaction. Certain associated legal fees, including particularly the indemnification payments made to the managers, may be currently deductible, notwithstanding that they were incurred in the milieu of a capital transaction.

Ordinary and necessary expenses in carrying on a trade or business are deductible.[1] Capital expenditures are not deductible.[2] Taxpayers must therefore capitalize amounts paid to acquire and to facilitate the acquisition of an ownership interest in a corporation, partnership, trust, estate, limited liability company or other entity.[3]

The Supreme Court in *Hilton Hotels Corp.*[4] held that "the expenses of litigation which *arise out of the* acquisition of a capital asset are capital expenses." In *F.W. Woodward*,[5] the companion case to *Hilton Hotels Corp.* (different only as a result of disparities in the operation of the underlying state corporate law),[6] the Supreme Court held that in evaluating litigation expenses, the costs of acquiring a capital asset should be determined by the "inquiry whether the *origin of the claim litigated* is in the process of acquisition itself." The Supreme Court had previously used this test to determine whether an expense was business or personal in *D. Gilmore*[7] and thus extended application of the "origin of the claim" test to characterizing litigation costs as either deductible expenses or capital expenditures.

In these two cases, the Supreme Court rejected application of the court-developed "primary purpose" test, in which expenses are of a capital nature only where the taxpayer's primary purpose in incurring them is to defend or perfect title. Since the costs of the appraisal proceedings to determine the value of the dissenting shareholders' stock had their origins in the corporate merger, the litigation expenses were characterized as capital expenditures.

Going back to a capital transaction, it may be argued that the origin of all of the claims that will be litigated is in the acquisition itself. After all, if not for the capital transaction, there would be no claims to litigate. It could be fairly stated that all of the expenses of the ensuing litigation arose out of the acquisition of the capital asset that was the subject of the capital transaction.

But, it could also be argued that a portion of the expenses of the ensuing litigation arose out of the indemnity of the managers that is ordinarily, necessarily and routinely provided to obtain their services as a matter of course. That is, the origin of the litigation claim when directors or managers are sued is the indemnity itself, an ordinary and necessary expense in carrying on a trade or business. This is part of the compensation package provided to the managers without regard to the nature of the transaction involving the company

Support for this position can be found in Judge Friendly's ruling in *Larchfield Corp.*[8] In this case, Larchfield contested bonuses paid in previous years to the controlling stockholder of the predecessor corporation, which were recovered as the result of a derivative action. At issue was the deductibility of legal expenses relating to that action.

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Judge Friendly rejected Larchfield's assertion of a general rule that all expenditures in connection with litigation for breach of fiduciary duty by a director are deductible. Since the main purpose was the recovery of property, the expenses were capital in nature to the extent directed towards that purpose. Insofar as the derivative action had objectives other than the recovery of specific property, the expenses were deductible *via* an allocation.

Judge Friendly differentiated the considerations determining the deductibility of the sums the corporation was ordered to pay to counsel for the plaintiffs in the derivative action from the fees incurred on behalf of itself and the amounts paid to counsel for the individual defendants under the indemnification by-law. The amounts paid to counsel for individual defendants under the indemnification bylaw were fully deductible. The payment of legal fees under such a by-law were reasonably characterized as a fringe benefit necessary to induce officers and directors to serve, deductible in any event to the corporation as reasonable compensation.

Judge Friendly held that the payments to the lawyers were not made in an effort by the corporation

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ENDNOTES

[1] *Historic Boardwalk Hall*, 136 TC No. 1, Dec. 58,501, *rev'd and rem'd*, CA-3, 2012-2 USTC ¶50,538.

[2] *Virginia Historic Tax Credit Fund 2001 LP*, 98 TCM 630, Dec. 58,032(M), *rev'd and rem'd*, CA-4, 2011-1 USTC ¶50,308, 639 F3d 129.

[3] *TIFD III-E, Inc.*, DC-CT, 2004-2 USTC ¶50,401, *rev'd and rem'd*, CA-2, 2006-2 USTC ¶50,442, 666 F3d 836.

[4] *S. Sacks*, 64 TCM 1003, Dec. 48,567(M), *vac'd, rev'd and rem'd*, CA-9, 95-2 USTC ¶50,586, 69 F3d 982.

[5] *NA General Partnership*, 103 TCM 1916, Dec. 59,094(M) (2012).

[6] *R.A. Hardman*, CA-9, 87-2 USTC ¶9523, 827 F2d 1409.

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to perfect title, but rather under a contract obligating it to pay for efforts to defeat the claim being made on its own behalf and were therefore deductible in full.

To figure out whether Judge Friendly's holding survived *Hilton Hotels Corp.* and *F.W. Woodward*, necessitates a deeper investigation into those cases. The Supreme Court's reasoning was as follows: The general principle is that costs incurred in the acquisition of property having a useful life substantially beyond the tax year is a capital expenditure. The establishment of a purchase price is clearly part of a purchase acquisition. Ancillary expenses incurred in acquiring a capital asset are as much part of the cost as the price paid. Thus, expenses incurred in litigation to set the price are properly treated as part of the cost of the acquisition. Hence, the litigation expenses incurred in appraisal proceedings determining that price should be included in the cost.

In the facts of these two cases, "there can be no doubt that legal ... costs incurred by taxpayers in negotiating a purchase of the minority stock would have been capital expenditures .... Under whatever test might be applied, such expenses would have clearly been 'part of the acquisition cost' of the stock."[9]

In light of such reasoning, it is evident that the legal costs of the directors are different from a limited liability company's own legal defense costs. The cases in which only the company and not the directors or managers are named as defendants are distinguishable.[10] The legal costs incurred in indemnifying the directors are not so clearly part of an acquisition the way the determination of the price of minority stock is part of the purchase. Such legal costs of director indemnification are more akin to the ordinary and necessary expense of directors and managers than to the acquisition of an asset. The capital transaction may be the spur for the legal costs, but the litigation expenses arise out of the indemnities.

The IRS has permitted ordinary and necessary business deductions for legal costs incurred in class-action lawsuits resulting from stock and note offerings.[11] The IRS recognized that business expenses are not converted into capital expenditures solely because they have some connection to a capital transaction. In the facts of the ruling, the alleged omissions or misrepresentations were in connection with the preparation and publishing of financial reports, making SEC filings or issuing press releases related to its business. Since these were regular business activities, the IRS held that the origin of these claims was in the ordinary conduct of the taxpayer's business.

The IRS condoned the notion of going beyond the apparent transaction at hand and delving deeper into the substance of the situation. "While technically the claims arise in the context of stock and note offerings, the actual origin of the claims was not a capital transaction but rather the ongoing alleged false statements and omissions." The IRS couched the legal test as "determining whether the claims had their origin in the conduct of Taxpayer's ordinary and necessary business activities or whether any of the claims were *rooted* in a capital transaction."[12]

In the context of a capital transaction, there is support for going beyond the superficial transaction for characterizing certain of the litigation costs. A taxpayer may argue that while technically claims may arise in the context of a capital transaction, the *root* of those claims is not in the capital transaction, but rather the ongoing regular business expense of compensating directors and managers.

The essence of *Hilton Hotels Corp.* and *F.W. Woodward* should countenance against the mechanical application of the origin of the claim test and instead direct its use toward the aim of identifying those costs properly part of the costs of an acquisition. "In determining the origin of a claim, the courts have looked beyond the formal characterization of the claim, and instead considered the substance of the entire transaction."[13] Since Judge Friendly's reasoning is con-